

August 31, 2005

**Comments on the “Tax Technical Corrections Act of 2005”
Submitted by
Washington Council Ernst & Young
On
The Definition of “U.S. Property” for Purposes of IRC § 956:**

Washington Council Ernst and Young (a division of the National Tax Practice of Ernst & Young, LLP, a professional services firm) represents a variety of clients on tax legislative, regulatory, and policy issues.

Introduction

This statement is submitted in response to the announcement by Senator Charles Grassley, chairman of the Senate Finance Committee, and Senator Max Baucus, ranking member, that S. 1447, the *Tax Technical Corrections Act of 2005*, would be available for public comment through August 31, 2005.

Our comments relate to section 407 of the American Jobs Creation Act 2004 (P.L. 108-357, the “Jobs Act”). The provision expanded the scope of investments in U.S. property that can be made by a controlled foreign corporation (CFC) without triggering a Section 956 subpart F inclusion for its U.S. shareholders. We believe that a technical correction is warranted to clarify that investments made by a CFC in REMIC regular interests are covered by new IRC § 956(c)(2)(M), and thus do not give rise to current income inclusions under subpart F.

Clarify That REMIC Regular Interests are Not U.S. Property for Purposes of IRC § 956

Section 407 of the Jobs Act added exceptions to IRC § 956, to allow CFCs to invest in an obligation issued by a U.S. person that is not a domestic corporation, a 10% U.S. shareholder of the CFC, or a partnership, estate, or trust in which the CFC or any related person is a partner, beneficiary, or trustee immediately after the acquisition by the CFC of such obligation (new IRC § 956(c)(2)(M)). Before amendment, the exception covered only obligations of U.S. corporations.

The new exception does not contain any reference to REMICs. The question thus arises whether regular interests in REMICs are included in the new definition of excluded U.S. obligations, so that CFCs can invest in REMICs without potentially triggering current subpart F inclusions for their U.S. shareholders.

Background Regarding REMICs

In the Tax Reform Act of 1986, Congress created a new mortgage securitization vehicle for tax purposes, the Real Estate Mortgage Investment Conduit (or REMIC), as the exclusive vehicle to issue multiple class mortgage-backed securities, and provided detailed, and exclusive, tax rules. Since 1986, REMICs have emerged as a vitally important component of the secondary mortgage market in the United States, helping to achieve America's historic high rates of home ownership. Single-family mortgage backed securities, which consist primarily of REMICs, grew from less than \$367 billion outstanding in 1981 to more than \$3.3 trillion outstanding in 2001, an 800% increase.¹

A REMIC can be structured as an entity (i.e., partnership, corporation, or trust) or simply as a segregated pool of assets, so long as the entity or pool meets certain requirements regarding the composition of assets and the nature of the investors' interests. No tax is imposed at the REMIC level. To qualify as a REMIC, all of the interests in the REMIC must consist of one or more classes of "regular interests" and a single class of "residual interests." Regular interests can be issued in the form of debt, stock, partnership interests, or trust certificates, or any other form of securities, but must provide the holder the unconditional right to receive a specified principal amount and interest payments. REMIC regular interests are treated as debt for Federal tax purposes. A residual interest in a REMIC, which is any REMIC interest other than a regular interest, is, on the other hand, taxable as an equity interest.

Although it appears clear that REMIC regular interests are "obligations" for purposes of IRC § 956, it is not clear whether a REMIC is either a corporation or even a person for purposes of that section, and, thus it is unclear whether REMIC regular interests are covered either by the exception for obligations of U.S. corporation or by the new exception for obligations of U.S. persons that are not U.S. corporations.

Analysis Supporting Technical Amendment That REMIC Regular Interests are Not U.S. Property for Purposes of IRC § 956

The proposed technical amendment would be consistent with subpart F principles – Subpart F imposes current taxation on U.S. shareholders (generally, greater than 10% owners) of foreign corporations owned more than 50% by U.S. shareholders with respect to certain types of passive or highly movable income. Under IRC § 956, subpart F also taxes U.S. shareholders currently on investments made by the CFC in U.S. property (with numerous exceptions). The rationale behind IRC § 956 is that such investments are akin to dividends to the U.S. shareholders. The numerous exceptions to "U.S. property" contained in IRC § 956(c)(2) (including those recently added by the Jobs Act) carve out from this definition true investments made by the CFC, i.e., those that are not made to send earnings back to the U.S. parent while deferring U.S. taxation of such earnings. Providing an exception to the definition of "U.S. property" for investments made by a CFC in REMIC regular interests would be consistent with the underlying purpose of subpart F and the exceptions to that definition now contained in IRC § 956.

¹ 2 Inside Mortgage Finance Publications, Inc., The 2002 Mortgage Market Statistical Annual, 107 (2002).

Avoid potential confusion in the marketplace and unexpected tax consequences – CFC investors, as a common business practice when purchasing commercial paper, focus their investment decisions on issues of yield, security, and term; it is often only after investing, and receiving the fund prospectus, that they would even realize that they have invested in a REMIC. Insuring that REMIC investments are taxed in an equivalent manner to comparable U.S. obligations will alleviate the potential marketplace confusion and disruption that could arise were REMIC regular interests to face a more onerous tax regime than equivalent non-REMIC obligations. Without the proposed clarification, CFCs would perceive investing in the U.S. mortgage market as more burdensome, and thus some could choose to invest in non-U.S. and non-mortgage markets.

Help liquidity of secondary mortgage markets – REMICs operate to keep the U.S. secondary mortgage market extremely liquid and have helped the U.S. to achieve historic levels of home ownership. Increased investments in REMICs helped achieve this laudatory goal. Enabling CFCs to invest in REMICs will enhance the liquidity of the secondary mortgage market.

Proposed Statutory Language

Statutory Language

We propose the following statutory language that would amend I.R.C. Section 956(c)(2)(M)(ii)(II) to read:

“a partnership, estate, ~~or~~ trust, *or REMIC* in which the controlled foreign corporation, or any related person (as defined in section 954(d)(3)), is a partner, beneficiary, ~~or~~ trustee, *or residual interest holder* immediately after the acquisition of any obligation of such partnership, estate, ~~or~~ trust, *or REMIC* by the controlled corporation *or a REMIC that predominantly holds any obligation of the controlled foreign corporation or any related person (as defined in section 954(d)(3)).*”

Legislative History

We further submit the proposed legislative history to accompany the foregoing statutory text.

“New subsection (M) does not contain any specific reference to REMICs. Nevertheless, it was intended that regular interest obligations issued by REMICs are eligible for the expanded exception from U.S. property for purposes of I.R.C. section 956. It was also intended that similar ownership restrictions that apply to partnerships, trusts and estates are applicable to REMICs, (e.g., so that U.S. shareholders cannot set up “captive” REMICs or a CFC hold REMIC regular interests of REMICs that predominately holds obligations of the U.S. shareholder). No inference is intended whether REMIC regular interests qualify

as a “United States person” for other sections of the I.R.C. Treasury is granted regulatory authority to ensure that obligations issued by REMICs are consistent with the underlying goals of the statute.”

Conclusion

We respectfully submit that the definition of a “technical correction” should be broad enough to encompass statutory amendments that clarify results that are consistent with the intent and scope of a provision (as in the treatment of investments made by a CFC in REMIC regular interests under IRC § 956(c)(2)(M)).